REPORT OF EXAMINATION
OF THE

LIFEGUARD LIFE INSURANCE COMPANY

AS OF
DECEMBER 31, 2000

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San Francisco, California
April 2, 2002

Honorable Harry W Low
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

LIFEGUARD LIFE INSURANCE COMPANY

(hereinafter also referred to as the Company) at its administrative office located at 2840 Junction Avenue, San Jose, California, 94134. The Company's statutory home office is located at 1851 McCarthy Boulevard, Milpitas, California, 95035.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 1996. This examination covers the period from January 1, 1997 through December 31, 2000. The present examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, an evaluation of assets, and a determination of liabilities as of December 31, 2000, as deemed necessary under the circumstances.

In addition to the items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas which require no further comments: company history; corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; mortality experience; and sales and advertising.

SUBSEQUENT EVENT

On December 31, 2001, the Company paid an ordinary dividend to its parent, Lifeguard, Inc., in the amount of $4,499,960. This transaction did not require approval by the California Department of Insurance.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which Lifeguard, Inc., is the ultimate controlling entity. Lifeguard, Inc. owns 100% of the Company. Members of the board of directors and principal officers serving at December 31, 2000 were as follow:

Board of Directors

Name and Residence City	Principal Business Affiliation
S. Joseph Aita, M.D. Napa, California	Executive Vice President and Medical Director Lifeguard, Inc.
Robert D. Burnett, M.D. Sunnyvale, California	Emergency Room Physician El Camino Hospital
Marguerite M. Callaway San Rafael, California	Vice President Kaiser Permanente Consulting Services
Victor J. DeFino, M.D. Saratoga, California	Assistant Medical Director Lifeguard, Inc.
Edward C. Geehr, M.D. Newport Beach, California	Chairman and Chief Executive Officer IPC, The Hospitalist Co.
Mark G. Hyde Palo Alto, California	President and Chief Executive Officer Lifeguard, Inc.
Julie Hyer, O.P. Aptos, California	President and Chief Executive Officer Dominican Hospital
Glenn C. Jones Monte Sereno, California	Retired

Board of Directors -continued

Name and Residence City	Principal Business Affiliation
Daniel Perez Gilroy, California	Vice President and Chief Administrative Officer Solectron
Agnieszka Winkler San Francisco, California	Chairman and Chief Executive Officer Winkler McManus Advertising
Arthur J. Young Los Altos, California	Vice President, Business Development 401Konnect.com

Principal Officers

Name	Title
Mark G. Hyde	President and Chief Executive Officer
Holly E. McCann	Vice President and Secretary
Joseph De Vita	Vice President and Chief Financial Officer
S. Joseph Aita M.D.	Vice President
William D. Rohde	Controller

Intercompany Agreements

The Company operates under a management agreement with its parent, Lifeguard, Inc. (Lifeguard), a health maintenance organization. Lifeguard provides all employees and administrative services, including but not limited to underwriting, premium collection, claims administration, accounting, sales and data systems management. Under the terms of the agreement, the Company agrees to pay Lifeguard a monthly management fee for all services provided based on costs incurred by Lifeguard. The Company pays such fee to Lifeguard within 30 days of the end of the month in which the costs were incurred. With regard to premiums, Lifeguard agreed to transfer to the Company within 30 days after the last day of the month of coverage associated with the premiums billed, an amount equal to the amount of the Company's premiums collected. In practice, Lifeguard paid the amount billed by the Company and not the amount collected. Lifeguard will absorb the amounts not collected from the members. The

Company's management has agreed to amend the agreement from the collected amount to the billed amount.

The Company and Lifeguard filed consolidated federal income tax returns during the period under examination. The Company had paid its share of the federal income tax as if it had filed the return separately; however, there was no written federal income tax sharing agreement between the two entities. It is recommended that the Company execute a federal income tax sharing agreement with Lifeguard as soon as possible and file the agreement with the California Department of Insurance.

TERRITORY AND PLAN OF OPERATION

The Company is licensed to write life and disability insurance in the State of California. Direct premiums amounted to $46.9 million in 2000. The Company issued health insurance policies to large (50+ employees) and small (2 to 50 employees) employer groups. Business is produced by agents or brokers in the San Francisco region, Greater Bay Area, Central Valley, and Coastal Regional counties.

The Company's products are only written alongside Lifeguard, Inc.'s products. The Company's Out of Area (OOA), Preferred Provider Organization (PPO), and Exclusive Provider Organization (EPO) products are not sold independently. Therefore, the business plan of the Company is closely linked to that of Lifeguard, Inc.

It was noted that the Company's agents have not been appointed by the Company and registered with the California Department of Insurance to solicit business for the Company. Pursuant to California Insurance Code Section 1704, each life agent or casualty broker-agent is required to file with the Insurance Commissioner a notice of appointment to act as agent for an insurer. It is recommended that the Company take corrective action in this matter.

REINSURANCE

Assumed

The Company has not assumed any reinsurance.

Ceded

On August 8, 2000, the Company and its parent, Lifeguard, Inc. (Lifeguard) entered into a catastrophic case management service agreement with Paradigm Health Corporation (Paradigm). Under this agreement, the Company can elect to refer premature and sick newborns to Paradigm for case management. The services provided by Paradigm include, but are not limited to, the following:

- Clinical assessment of the neonate.
- Rate negotiation with health care providers.
- Consultation with health care providers.
- Education of the baby's primary family caregiver regarding medical condition and treatment options.
- Facilitation of the initial discharge.
- Recommendations regarding appropriate provider facilities and care after initial discharge.
- Development of medical outcome plans.

For the services rendered, Paradigm, in effect, charges the Company an assigned case rate based on the neonate's weight and/or severity of the medical condition. The agreement provides for the Company to pay for all medical costs incurred. However, the agreement also includes a provision that provides that if the medical cost of treating the neonate exceeds the assigned case rate less $10,000, Paradigm will pay the Company the difference. It appears that this provision may create an indemnification/reinsurance relationship between the two entities. Paradigm, however, is not a licensed insurer and may therefore be in violation of California Insurance Code Section 700 by transacting the business of insurance without a license. Currently, the number of neonate cases that have been managed by Paradigm for the Company have been minimal.

The Company is of the opinion that there is no element of indemnity in the agreement and that the agreement covers business and not insurance risks. The examiners have referred this issue to the California Department of Insurance's Legal Division for further analysis.

Prior to January 1, 2000, the Company along with Lifeguard had an excess of loss contract with Allianz Life Insurance Company of North American. This contract was not renewed because the companies considered the premiums to be excessive.

ACCOUNTS AND RECORDS

Information System Controls

A review was performed of Company's general controls over its information systems. As mentioned in the last Report of Examination, it does not have a comprehensive and tested business contingency and disaster plan. Without a complete formal business contingency and disaster plan, the Company would not have a coordinated recovery response effort in the event of a business interruption. In addition, downtime may be extended resulting in potential loss of revenue and/or customers. The Company's management stated that a disaster recovery plan is in the process of being developed.

The review also revealed other control weaknesses in areas such as application controls, physical security and data retention. The weaknesses noted were presented to the Company's management along with recommendations to strengthen its controls. The Company should evaluate the recommendations, and make appropriate changes to strengthen its information system controls.

General Expenses

The Company did not complete Exhibit 5 – General Expenses of the Annual Statement properly. Pursuant to the Annual Statement Instructions, management fees should not be reported as a one-line expense. The expenses should be allocated to the appropriate expense classification item as if these costs had been borne by the Company. It is recommended the Company take corrective action on this matter.

Schedule "O"

In Schedule "O", the Company only reported 24 months' of development for all incurred years. It is recommended that the Company complete Schedule "O" correctly

Reconciliation of Loss Data

The examiners were unable to reconcile some of the loss data that were used by the Company's actuarial and accounting departments. The Company was unable to provide explanations of the differences. It is recommended that the Company's accounting department reconcile the loss data with the data used by the actuarial department on a regular basis.

FINANCIAL STATEMENTS

The financial statements prepared for this report include the following:

Statement of Financial Condition as of December 31, 2000

Summary of Operations and Capital and Surplus Account for the Year Ended December 31, 2000

Reconciliation of Capital and Surplus from December 31, 1996 through December 31, 2000

Reconciliation of Examination Changes as of December 31, 2000

Statement of Financial Condition
as of December 31, 2000

Assets	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	$12,364,146	$	$12,364,146	(1)
Cash and short-term investments	2,669,408		2,669,408	(2)
Accident and health premiums due and unpaid	16,490,431		16,490,431	(3)
Investment income due and accrued	225,405		225,405	
Other assets nonadmitted	69,661	69,661		
Total assets	$31,819,051	$ 69,661	$31,749,390	

Liabilities, Surplus and Other Funds			
Policy and contract claims: Accident and health		$ 9,689,653	(4)
Commissions to agents due or accrued		414,421	
General expenses due or accrued		4,139,573	(5)
Taxes, licenses and fees due or accrued		788,814	
Amounts withheld or retained by company as agent or trustee		99,349	(6)
Asset valuation reserve		31,821	
Aggregate write-ins for liabilities		44,741	
Total liabilities		15,208,372	
Common capital stock	$ 2,500,200		
Gross paid-in and contributed surplus	6,249,800		
Unassigned funds (surplus)	7,764,018		
Surplus as regards policyholders		16,541,018	
Total liabilities, surplus and other funds		$31,749,390	

Summary of Operations and Capital and Surplus Account
for the Year Ended December 31, 2000

Statement of Income

Premiums and annuity considerations	$46,920,412
Net investment income	1,163,946
Amortization of interest maintenance reserve	9,665
Total	8,094,023
Disability benefits and benefits under accident and health policies	32,770,781
Commissions on premiums and annuity considerations	2,144,024
General insurance expenses	5,963,973
Insurance taxes, licenses and fees, excluding federal income taxes	1,117,592
Total	41,996,370
Net gain from operations before federal income taxes	6,097,653
Federal income taxes incurred	2,312,000
Net income	$ 3,785,653

Capital and Surplus Account

Capital and surplus, December 31, 1999		$12,763,289
Net income	$3,785,653	
Change in asset valuation reserve	(7,924)	
Net change in capital and surplus for the year		3,777,729
Capital and surplus, December 31, 2000		$16,541,018

Reconciliation of Capital and Surplus
from December 31, 1996 through December 31, 2000

	Gain in Surplus	Loss in Surplus	
Capital and surplus, December 31, 1996, per Examination			$ 8,928,046
Net income	$7,612,681	$	
Change in nonadmitted assets	15,961		
Change in asset valuation reserve		15,670	
Total gains and losses in surplus	$7,628,642	$ 15,670	
Net increase in surplus			7,612,972
Capital and surplus, December 31, 2000, per Examination			$16,541,018

Reconciliation of Examination Changes
as of December 31, 2000

Liabilities	Per Company	Per Examination	Surplus Increase (Decrease)	Notes
Policy and contract claims:				
Accident and health	$9,268,141	$9,689,653	$ (421,512)	(4)
General expenses due and accrued	3,877,357	4,139,573	(262,216)	(5)
Amounts withheld or retained by company as agent or trustee	68,770	99,349	(30,579)	(6)
Net decrease to surplus			(714,307)	
Surplus as regards policyholders, December 31, 2000, per Company			17,255,325	
Surplus as regards policyholders, December 31, 2000, per Examination			$16,541,018	

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Bonds

The Company executed a custody agreement with BNY Western Trust Company effective August 5, 1997; however, this agreement has not been submitted to the California Department of Insurance (CDI) for approval as required under California Insurance Code Section 1104.9(c). It is recommended that the Company submit the agreement to the CDI as soon as possible.

(2) Cash and Short-Term Investments

In the past, the Company did not maintain a list of outstanding checks that had been reclassified to an unclaimed fund liability account. In 1999, the Company hired its external auditor, Ernst & Young (E&Y), to develop a system to record old outstanding checks and to estimate the escheat liabilities for checks that were issued in 1998 and prior. Those estimated amounts have been paid to the State Controllers' Office; however, the Company has not implemented the system recommended by E&Y to handle unclaimed properties. It is recommended that the Company implement the system as prescribed by E&Y.

(3) Accident and Health Premiums Due and Unpaid

The captioned account included two short-term loans totaling $6.6 million that the Company made to its parent, Lifeguard, Inc. in two separate transactions in December 2000. The loans bore no interest. Since the total of the two transactions exceeded three percent of the Company's admitted assets as of the preceding December 31st, the Company violated California Insurance Code (CIC) Section 1215.5(b) by not obtaining approval from the Insurance Commissioner prior to the consummation of the transactions. During the examination, the Company filed an application with the Insurance Commissioner to have the loans approved retroactively. It is recommended that the Company comply with the Insurance Holding Company System Regulatory Act in the future.

Because Lifeguard performs premium billing and collection for the Company, the Company records premium receivables due from Lifeguard in an inter-company account. However, premium transactions are commingled with other non-premium transactions that occur between the companies. It is recommended that the Company establish a separate inter-company account to account for items other than premiums.

(4) Policy and Contract Claims: Accident and Health

The examination amount is $421,512 greater than the amount reported by the Company. The increase was based on an eight-month loss development of the medical claims unpaid as of December 31, 2000.

(5) General Expenses Due and Accrued

The examination amount is $262,216 greater than the amount reported by the Company. The above amount represents loss adjustment expenses in connection with medical claims unpaid at year-end 2000. Pursuant to Annual Statement Instructions, the Company is required to establish this liability.

(6) Amounts Withheld or Retained by Company as Agent or Trustee

The examination amount is $30,579 more than the amount reported by the Company. The reported amount in this account represents withholdings of up to 15% of compensation paid to medical providers for services rendered. The Company returns all or a portion of the funds withheld to the providers based on the Company's determination as to whether the providers provided cost-effective and quality health care services to its members. The examination increase represents the amounts withheld in the first six months in 2000 which the Company did not record in its general ledger. Company management stated that it only started recording this liability in July of 2000.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Intercompany Agreements (Page 3): It is recommended that the Company execute a written federal tax sharing agreement with its parent and submit the agreement to the California Department of Insurance when completed.

Territory and Plan of Operation (Page 4): The Company's agents have not been appointed by the Company and registered with the California Department of Insurance to solicit business for the Company. It is recommended that the Company correct this oversight.

Reinsurance - Ceded (Page 5): The Company's agreement with Paradigm Health Corporation (Paradigm) may contain a provision that provides indemnification of the Company. Paradigm may be in violation of California Insurance Code Section 700 for conducting the business of insurance without a license.

Accounts and Records - Information System Controls (Page 6): It is recommended that the Company make appropriate changes to strengthen its information system controls.

Accounts and Records – General Expenses (Page 6): The Company should properly complete Exhibit 5 – General Expenses in its Annual Statement.

Accounts and Records – Schedule "O" (Page 7): The Company should complete Schedule "O" correctly in its Annual Statement.

Accounts and Records – Reconciliation of Loss Data (Page 7): It is recommended that the Company reconcile loss data used by the actuarial department to the accounting department's records on a regular basis.

Comments on Financial Statement Items – Bonds (Page 12): It is recommended that the Company submit a completed and executed custody agreement to the California Department of Insurance as required under California Insurance Code Section 1104.9(c).

Comments on Financial Statement Items – Cash and Short-Term Investments (Page 12): The Company has not implemented procedures to handle old outstanding checks. It is recommended that the Company implement the system setup by Ernst & Young to handle unclaimed properties.

Comments on Financial Statement Items – Accident and Health Premiums Due and Accrued (Page 12): It is recommended that the Company comply with the Insurance Holding Company System Regulatory Act in future dealings with its parent company. It is recommended that the Company establish a separate inter-company account to account for items other than premiums.

Comments on Financial Statement Items – Policy and Contract Claims: Accident and Health (Page 13): The Company's reserve for medical claims at year-end 2000 was deficient by $421,512 based on an eight-month loss development.

Comments on Financial Statement Items – General Expenses Due and Accrued (Page 13): The Company did not establish a reserve for loss adjustment expenses in connection with medical claims unpaid at year-end 2000. It is recommended that the Company establish this liability in the future.

Comments on Financial Statement Items – Amounts Withheld or Retained by Company as Agent or Trustee (Page 13): The Company only started recording the amounts withheld from medical providers in its general ledger in July 2000. This resulted in an examination adjustment of $30,579.

Prior Report of Examination

Corporate Records (Page 4): It was recommended that the Company comply with California Insurance Code Sections 735 and 1201. The Company has complied with these code sections during the period under examination.

Reinsurance (Page 5): It was recommended that the Company amend its reinsurance agreement with Allianz Life Insurance Company of North America in order to comply with California Insurance Code Section 922.2(a)(2). The Company cancelled this agreement on January 1, 2000.

Accounts and Records (Page 6): The Company did not complete the Notes to the Financial Statement in the 1996 Annual Statement. Also ceded reinsurance was not reported in Exhibit 1, Part 1, and Schedule 1, Part 1. The Company has complied with the above requirements during the period under examination.

Comments on Financial Statement Items – Bonds (Page 10): Securities were not filed in accordance with the National Association of Insurance Commissioners (NAIC) Valuations of Securities (VOS) manual. The Company has complied with this requirement during the period under examination.

Comments on Financial Statement Items – Cash (Page 10): The Company did not have a system to follow-up on long outstanding checks and escheat of uncashed checks. Each month, the Company cleared its outstanding checks over nine months outstanding to income. The Company has stopped moving long outstanding checks to income. In 1999, the Company hired Ernst & Young to establish a system to follow-up and escheat long outstanding checks; however, the Company has not implemented the system.

Comments on Financial Statement Items – Interest Maintenance Reserve (Page 10): It was recommended that the Company amortize investments over its life using the scientific method of amortization. The Company has complied with this requirement.

ACKNOWLEDGEMENT

Acknowledgement is made of the cooperation and assistance extended by the officers and employees of the Company and its parent during the course of this examination.

Respectfully submitted,

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Kelvin Ko, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California